The American Antitrust Institute

TESTIMONY OF THE AMERICAN ANTITRUST INSTITUTE

BEFORE THE U.S. HOUSE OF REPRESENTATIVES COMMITTEE ON TRANSPORTATION AND INFRASTRUCTURE, SUBCOMMITTEE ON AVIATION,

ON THE PROPOSED UNITED-CONTINENTAL MERGER:

POSSIBLE EFFECTS FOR CONSUMERS AND INDUSTRY

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Introduction

I am Albert A. Foer, President of the American Antitrust Institute. The AAI is a 12-year-old independent non- profit education, research, and advocacy organization. We operate as a network of more than 100 antitrust experts, including men and women trained and experienced in law, economics, and business. The AAI believes that the vigorous enforcement of the antitrust laws is the best way to protect consumers, innovation, and the economy as a whole from anticompetitive corporate behavior, and in this way ensure that competition will be both aggressive and fair. For further background, visit www.antitrustinstitute.org. We are currently working on a white paper on the proposed United-Continental merger that we will make available to the Committee when it is completed. Testimony on the United-Continental merger was presented on May 27 to the Senate Judiciary Committee on behalf of

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the AAI by Professor Darren Bush of the University of Houston Law Center.[1]

I previously testified before this Committee in 2008, to discuss the merger between Delta and Northwest.[2] I confess to having succumbed to the temptation to submit nearly the identical testimonial statement, substituting the names United and Continental for Delta and Northwest. In that earlier testimony, I predicted, along with many others, that a merger between United and Continental would follow if Delta-Northwest was permitted. Today I'll predict that there will be one more major consolidation, perhaps between American and US Airways, if the current merger is permitted. The American consumer will then be left with three national network carriers plus Southwest, and a few small low cost point-to-point carriers.

Since most of my analysis today closely resembles my analysis in 2008, my first recommendation to the Subcommittee is to hold retrospective hearings on the Delta-Northwest merger. Has it accomplished its stated objectives? Is the American consumer better off? Has competition been adequately protected? Were projected efficiencies obtained? I do not have answers to these questions to offer at the moment, and I do not know if enough time has gone by for enough integration of the two airlines to have been achieved so that a convincing evaluation currently can be made; but there is no question the answers would be invaluable in our efforts to predict the implications of a United-Continental marriage. Indeed, it might make sense to delay the consummation of this merger until a credible study of the prior merger can be taken into account. This is too important a decision to be rushed. Indeed, as a matter of policy, all questionable mergers that are permitted should be conditioned on making follow-up evaluatory data available.

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[1] http://www.antitrustinstitute.org/archives/files/Bush%20Testimony%205-27_052720101125.pdf (May 27, 2010).

[2] http://www.antitrustinstitute.org/archives/files/TESTIMONY%20Delta-NW%20AAI%20%205-14-08_051420080959.pdf (May 14, 2008). We also issued a more extensive White Paper, http://www.antitrustinstitute.org/Archives/deltaNWpaper.ashx.

1. Getting the Perspective Right

It is critical to place this merger into context. I will be using the terms "network" and "system" more or less interchangeably. The essential points are that: (1) this is an industry in which there are substantial network effects, but the incremental costs of expanding an already large network may offset the network benefits; (2) the industry is already concentrated on a national basis, but this generalization underestimates the market power that is present at most hubs and on most routes; (3) a merger of this magnitude will in all probability lead to at least one more merger of similar size; and (4) this merger will itself likely lead to rationalizing capacity by closing or scaling back hubs, probably in the Midwest, which will harm a significant number of consumers. These considerations require us to ask not only the standard question of whether this merger should be allowed to go through after requiring the divestiture of identifiable overlapping city pairs in a few concentrated routes, but also the more fundamental question of whether the four or possibly three national networks that will emerge from this process will be sufficient to provide a satisfactory range of choice and service and sufficient competition to keep prices close to costs.

The airlines predictably assert that the merger brings efficiency benefits from economies of scale and scope, but these—to the extent they are likely to be realized-- must be weighed against inefficiencies due to other diseconomies of scale and scope and the reduction in competition between systems arising from the merger. For consumers not to be harmed, the benefits of the merger must outweigh the costs *and* at least some of these net benefits must be passed on to consumers in the form of lower prices and improved service.

2. The Limits of Standard Antitrust Analysis

Standard antitrust analysis focuses on horizontal overlaps between airport pairs and (in certain markets) between city pairs. If an origin and destination route is served by only a few airlines and the merger will leave the particular market more highly concentrated, the DOJ will likely—and properly—require a divestiture or some other arrangement with respect to that route, as a condition of approving the transaction. Because this is standard operating procedure, I will not address it further, except to note that this conventional approach tends to downplay the important role of potential competition in airline markets. Airlines not presently serving a route but which can fairly readily enter, serve to constrain pricing, and mergers that eliminate such a constraint may be anticompetitive just like mergers between airlines that currently do serve the market.

Standard overlap analysis is necessary but it should not be considered sufficient, because it captures only one part of the competition picture. In many markets, additional capacity can enter or depart a given city pair route with ease, which suggests that substantial competition occurs at the network level. Additional observations about competition at the network level will be provided later in this statement.

In contemplating an airline merger, the observer's lens needs to be adjusted in order to look not only at the trees but also at the forest. A more complete analysis must answer these questions: how many airline networks or systems are enough to guarantee the kind of pricing, service, convenience and innovation that the American public desires from its air transportation industry? How many are enough to provide the current competition or potential entry on specific routes that can serve as a constraint on higher prices by other systems?

3. Three Business Models

The airline industry in the U.S. consists of carriers following three principal business models: network, point-to-point, and hybrid. There are currently five major network carriers (American, Continental, Delta, United, and US Airways). Other carriers, including those that are categorized as "low cost carriers" and "connectors" either operate point-to-point or, as is the case of Southwest, have begun to move to a kind of hybrid of point-to-point and hub-oriented service.

It is possible, I suppose, that one day Southwest will become a national network carrier, but that remains to be seen. As things stand today, with United and Continental saying they will not close any hubs and Delta not having closed any hubs, it seems unlikely that Southwest would evolve into an additional network system within the coming few years. There are disadvantages as well as advantages to a network strategy, which will be discussed below.

The non-network carriers do play a role as competitors to the networks. In terms of capacity as measured by available seat miles, United-Continental will have over 200 million; Delta about 200 million; American about 150 million; Southwest about 100 million; and US Airways about 70 million. Airtran and Alaska will each have about 23 million.[3]

Southwest clearly influences prices wherever it competes, and there may be an effect even when Southwest is perceived as a potential competitor. But Southwest and the other low cost carriers have found their success by competing indirectly rather than directly with the networks. They are called low cost carriers in large part because they do not bear the costs of large networks. They do not offer the same type of one-stop shopping, frequent flyer benefits, or airport amenities as network carriers.

Decisions about the future of domestic air transportation should not rest on the concept that Southwest will always be around to provide price competition. Its strategy could change. Its management could make mistakes. It could choose to relax under the price umbrella of a tight oligopoly of network carriers. Public policy in the air transport sector should not rest on the shoulders of a single, albeit very successful maverick.

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[3] GAO, Airline Mergers, Testimony before the U.S. Senate Committee on Commerce, Science, and Transportation, May 27, 2010, at 13.

4. The Importance of Systems from a Network Perspective

There is some question as to whether the DOJ considers networks relevant from the demand side. Airline passengers benefit through network effects. When an airline adds service between its hub and a new location to accommodate passengers at that location, it also creates new service offerings between that location and other locations that can be reached through its hub. Code-sharing arrangements between airlines and other alliance functions can also facilitate network effects to the extent they promote coordination of schedules, route expansion, and the appearance of increased flight frequency.

From the perspective of the individual non-business air traveler, whether or not a carrier is part of a network may or may not be important, depending on what service is available from the origin to the ultimate destination. The benefit of a larger network is that it enables a consumer at any given city to reach more cities on the same airline, although most if not all of the additional choices involve changing planes. (The enhanced ability of a consumer to fly non-stop rather than via multiple legs would be an important consumer benefit. A one-stop journey generally adds at least an hour to a trip and increases the risk not only of delay but of danger in that most accidents occur on takeoff or landing.) If the traveler has frequent flyer miles, he or she may be biased to stay within a particular system, and indeed this may be a factor that makes new entry more difficult and which grows in value with the scope of the network.

From the perspective of businesses that negotiate the purchase of large amounts of travel service requiring specific scheduling, there is an advantage in that a single negotiation can cover a larger fraction of potential destinations and origins of flights.

If two airlines merge, both business and non-business customers receive a convenience benefit only if the average number of hops to reach all destinations goes down. For this to be a non-trivial effect, there must be significant cities that are not served by one of these carriers. Otherwise, one can get to any other city in one or two hops on either carrier.

Although networks may bring important consumer benefits as they grow, the incremental network benefits may decline as carriers get larger. Expanding a network by merger may add city-pair routes to those offered by the merged entity, but it is unlikely to create an in-system benefit to any given consumer if both carriers serve all major airports through each hub. Because low cost carriers compete only on certain non-stop routes, they provide at best only a limited discipline on a system-wide basis.

Network or system competition therefore should be taken into account in antitrust analysis from both the demand and supply side.

5. The Value of Considering Systems Competition

Each network can also be thought of as a "system," and we can say that for many purposes and for many travelers today, a particular travel experience can usually be accommodated by only one or two systems. Price competition on overlapping point-to-point routes is not the only dimension of rivalry under a systems view of airline competition. Travelers also look to the ease of connections, arrival and departure times, airport amenities, seamless baggage transfers, frequent flyer programs, etc. in making their airline choices. But airlines tend to think of their seats as a commodity, such that the systems carriers usually do not want to fly head-to- head against each other in circumstances where price would be the only differentiating factor-- which results in relatively few choices of airline for most non-stop flights.

One of the unique aspects of the proposed United-Continental merger is that both airlines are already part of the Star Alliance and to some extent already cooperate. A merger, of course, is broader in scope and has more thorough sharing than an alliance, whereas independent airlines can pull out of an alliance or switch alliances, and thus resume a more competitive role. A horizontal merger is forever.

6. The Role of Entry

What barriers constrain entry in the form of route expansion? With a number of important exceptions, mostly in congested airports serving hub functions, gates are not constrained. Importantly, dominant airlines have succeeded in deterring entry at their hubs through predatory strategies (such as temporary lower pricing perhaps combined with more flights and more promotional advertising) which neither antitrust nor regulation has been able to stop. To a large degree, it is a matter of strategic decision for the larger airlines whether they want to compete on certain routes. Why cannot United and Continental independently expand routes to gain greater network effects? Why is it more costly for United to add service rather than to buy the service from Continental, which is the practical effect of this merger? Overarching may be the efficiency question of why the most successful airlines are smaller, if network effects are supposed to be the dominant factor in airline success?

Whether non-system airlines such as Southwest, Airtran, Jet Blue and Frontier will become more like the system airlines is not clear and their potential entry as systems should therefore not be counted on in our current analysis of the industry. If two or more mergers of systems carriers occurs, Southwest and other non-system carriers may have the opportunity to pick up additional routes and perhaps even hubs, if hubs are abandoned or associated assets must be divested as a condition to merger clearance– possibilities that should not be taken for granted. Moreover, the non-network carriers might benefit from a raised price umbrella if a less competitive network strategic segment is able to raise its prices. Keep in mind that a low cost carrier that competes directly against a network carrier may not be in position to expand its output (i.e., carry more passengers), even though a price increase by the network carrier might encourage some passengers to switch carriers. If carrying more passengers is not feasible, the low cost carrier might as well raise its own prices.

Entry is particularly difficult in several well-known congested airports. Government policies could make entry for low cost carriers easier, which would improve the competitive situation in those airports. But such other factors as corporate contracts between businesses and network airlines, frequent flyer lock-in, and the difficulty of obtaining financial capital, availability of planes, and the FAA requirements for operating cash on hand are among the reasons why the public cannot count on low cost carriers to discipline post-merger price increases in the absence of vigorous competition between the systems airlines.

7. Using Caution in Considering the Parties' Efficiency Claims

If there is one thing that we have learned from the long history of antitrust, it is that efficiencies are easy to assert, difficult to achieve, and rarely of the magnitude that the parties project.

As in the Delta-Northwest merger, the principal efficiency claims being put forward in justification of this merger are economies of scale and scope on the supply side and rationalization of the use of planes to "right-fit" them to their routes.

The network airlines initially obtained large supply-side cost economies through the hub and spoke system resulting from increased traffic density, particularly as they induced increased passenger volumes on hub-to-hub flight segments. However, it appears that a system which relies too heavily on hubs is expensive to operate compared to a point- to-point system, and that there may be limits to the efficiency gains achievable through networks. For example, bigger networks create peak-load problems at an airport. The basic idea of a network is that all planes arrive at an airport at about the same time, the through-passengers then reassemble on different planes, and the planes depart at about the same time. This increases the disparity during the day in the number of arrivals and departures, and so creates problems for efficient staffing of gate, ticket, and maintenance personnel. By contrast, back-and-forth non-stops and multistep puddle jumps do not create as much of a peak-load problem.

The structure of the networks means that if weather or a mechanical problem causes a delay in the arrival of a plane at a hub, the problem quickly metastasizes throughout the system, as each delay causes a multitude of other delays. As networks grow, therefore, minor inconveniences become major national inconveniences, if not emergencies.

It is an empirical, not theoretical, issue to identify the point at which an airline begins to experience diseconomies of scale and scope. For mergers among big carriers, no one has found a significant net benefit. As such, many of the efficiency claims by the parties should be viewed with some skepticism and with a healthy concern about the potential fragility of a small number of very large systems.

For example, United and Continental say they anticipate large savings because they operate different types of aircraft and, if merged, the new company can "right-size" by flying more small or large planes on short or long routes. A proper analysis will ask the following questions and answer them with the help of experts not employed by the companies: (1) To what extent can these changes be made internally over time? (2) Why can't these friendly, Star Alliance airlines simply swap some assets to accomplish these changes? Wouldn't this be in each airline's interests? (3) Given that many planes are leased, why is a merger the only way to right-fit planes to their routes? In any event, the projected savings from this type of efficiency need to be scrutinized route-by-route and system-wide.

8. Strategies and Counter-Strategies

United and Continental justify their merger in terms of the desirability of increased scope – which they refer to as "presence" – and scale. They argue that the savings they can attain will help them survive the current fuel crisis and economic downturn. Implicitly, the economies of scope and scale cannot be maximized until a company is as large as the combined United and Continental. Of course, low profitability has been a chronic complaint of the large airlines regardless of merger activity, which has been plentiful over the years since deregulation.

The very same motivations were cited by Delta and Northwest. Northwest actually predicted that their merger would likely lead to at least one additional systems merger in the near term. They reasoned that the other systems carriers will see that the new largest carrier has unit cost advantages deriving from the economies and will have no choice but to quickly emulate the size of Delta via the only possible method, which is merger. Presumably the remaining four network airlines would also have to find a way to bulk up. Thus, we concluded, if Delta and Northwest were right, the merger wave that their merger kicked off would not stop there. If United-Continental goes through, American and US Airways will have to find dancing partners, perhaps with each other, and we will be down to three national networks.

On the other hand, if Delta and Northwest were wrong about the efficiencies, then there was no justification for distorting the equilibrium of six systems and there is no justification for going down to three. We see no reason to believe that the benefits of merger are due to efficiencies rather than expanding market power and we are therefore quite skeptical about the current proposal.

Giving additional market power to the airlines that survive the mergers will not reduce the price of fuel. That is out of the airlines' control and will have to be passed on to consumers. This will predictably result in fewer people flying. The question is whether the inevitable downsizing needs to be handled through shrinkage of the industry by mergers or through individual operational decisions by the incumbent airlines. It is our commitment to competition in the airline industry, as opposed to regulation, that is fundamentally at stake here. Downturns are cyclical and the country will be better off in the next growth period if there are more rather than fewer systems in competition with one another.

We are at a critical moment in the structural history of the US air transportation industry. While there are a few instances in which an antitrust agency has looked at two proposed mergers in the same industry simultaneously, the usual approach is to say that the agency can only consider that which is immediately before it. Taking this narrow view would be a disservice to the public, which is already concerned about the increasing unreliability and discomfort associated with air travel. While we have no inside knowledge that a follow-on merger by American and/or US Airways or perhaps by others is in the works, it will be extremely difficult to argue against the next one if Delta and United will have both been allowed to have their mergers. We urge that the antitrust analysis take the broad view of the industry's future. The strategic plans and counter- plans of all large carriers must be examined and analyzed before any antitrust decision is rendered.

CONCLUSION

The ultimate question is whether the public will be satisfied with three domestic and three global air transportation systems. There is little if any empirical knowledge that says how many systems are needed to provide a workable degree of intersystem competition. There is substantial data, both empirical and theoretical, that suggests that competitive problems increase as a market becomes highly concentrated. There is substantial experience with domestic air mergers that suggests how difficult they are to execute successfully; how few efficiencies have resulted from big carrier mergers; and how minimal entry has been at the network level. To the extent there is doubt about the United-Continental merger, it should be resolved as essentially a public policy question as to whether we are willing to interfere with business decisions in order to preserve the few competing systems, at the possible expense of whatever efficiencies might realistically be lost. We suggest that the magnitude and certainty of these proclaimed efficiencies should be analyzed with great skepticism and must be weighed against inefficiencies due to other diseconomies of scale and scope, the cost of consummating the merger, and the reduction in competition arising from the merger. From a public perspective there should be no reason to rush a decision on whether the allow United and Continental to merge and it would make particularly good sense to examine the effects of the most recent similar merger, Delta and Northwest, before opting for further consolidation.